

WRITTEN STATEMENT

OF

OLIVER I. IRELAND

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AND CONSUMER CREDIT

OF THE

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

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Good afternoon Chairwoman Maloney and Ranking Member Gillmor. My name is Oliver Ireland. I am a partner in the financial services practice in the Washington, D.C. office of Morrison & Foerster LLP. I have over 30 years of experience in financial services issues. I am currently the chair on the American Bar Association Deposit Accounts and Payments Subcommittee of the Committee on Consumer Financial Services. In addition, I was an advisor to the National Conference of Commissioners on Uniform State Laws Drafting Committee for the 1990 revisions to Articles 3 and 4 of the Uniform Commercial Code. I also worked for the Federal Reserve System for 26 years and spent 15 years as an Associate General Counsel of the Board of Governors of the Federal Reserve System (“Board”) in Washington, D.C. In my capacity at the Board, I was responsible for drafting Regulation CC, which implemented the Expedited Funds Availability Act (“EFAA”), and, in doing so, substantially revamped the check return system. I was also responsible for drafting and interpreting certain Board regulations affecting deposit accounts including the regulation governing reserve requirements, which distinguishes between savings deposits and transaction accounts based on the level of transactions, the regulation implementing the prohibition against the payment of interest on demand deposits, and was responsible for legal support of the Board’s own overdraft policy, which governs overdrafts by depository institutions in their accounts at Federal Reserve Banks. I have also litigated and served as an expert witness in cases involving dishonored checks and have advised private clients in connection with the treatment of deposit account overdrafts.

I am pleased to be here today to discuss the issue of depository institution practices with respect to overdrafts in deposit accounts. This issue has a long history and has been the focus of considerable regulatory and legal attention. It is an important component of deposit transaction

account services and an area of significant competition. Overdrafts are the lubricant that helps to facilitate the smooth flow of payment transactions that is critical to a market economy.

### **Overdrafts vs. Failed Payments**

From time to time, holders of deposit accounts at depository institutions that are used for the purpose of making third-party payments experience a mismatch between the funds available in the account to cover transactions and the depositor's need to make payments out of the account. If the amount needed for payments exceeds the available balance in the account, one of two things occurs—either one or more payments out of the account is rejected by the account holding depository institution or the account holding depository institution honors the payments, putting the account into an overdrawn, or overdraft, position.

The consequences of a rejected payment can range from inconvenience because the account holder cannot access funds for an anticipated discretionary expense to a failure of payment for an otherwise completed transaction that leaves a seller of goods or services in the position of trying to obtain payment from a remote purchaser and the purchaser potentially subject to criminal penalties under state bad check laws. Returned checks and ACH transactions also lead to charges imposed by a business that received the returned check or ACH transaction, possible disruptions in services, including such services as insurance coverage, and damage to the reputation of the person making the payment. Indeed, Article 4-402 of the Uniform Commercial Code expressly recognizes that a depository institution's liability for wrongful dishonor of a check can include damages for arrest and prosecution. In addition, there will be operational costs involved in dealing with the failed payment. In the case of check and ACH transactions, these costs can be significant and the return operations must be performed properly

and in a timely manner in order to avoid liability to other parties in the payment process, including the intended recipient of the payment.

Although the difficulties that ensue from a failed payment are often greatest when there is a time lag between the acceptance of a payment transaction and the time when a recipient of the payment learns that the payment has failed, even in transactions where the likely success of the transaction can be determined at the time of the transaction, such as a debit card payment, a failure of the payment to be authorized may put the cardholder in the position of having consumed a meal or otherwise owing funds for a transaction and being unable to make the payment.

The consequences of honoring a payment transaction that would overdraw an account are also significant, but more manageable. The payment transaction, and therefore most likely the underlying commercial transaction, will be completed. The account holding depository institution will have a claim on its customer, and the attendant credit risk for the amount of the overdraft. If the customer overdrawing the account is a good customer of the depository institution, this risk will be small. Nevertheless, check kiting schemes and other forms of payment fraud are not uncommon and depository institutions must be vigilant to control the risks from payment transactions, and particularly overdrafts.

In either honoring or rejecting a payment transaction that exceeds the available balance in a customer's account, a depository institution will often impose a fee. This fee serves to compensate the depository institution for its operational costs, risk of repayment and operational risk. The fee also serves to control risks and costs by discouraging undue reliance on overdrafts by deposit account customers.

## **Determining the Balance Available for Payments**

The overdraft issue is complicated by the fact that transaction accounts, whether commercial or consumer, typically receive deposits in a variety of forms including cash over the counter, checks and electronic payments through the ACH system or through Fedwire. These different forms of payment result in funds that the depository institution can safely treat as final at different times. Cash, barring counterfeits and counting errors that are discovered later, and Fedwires are typically final when received and therefore may be available to the customer for transactions as soon as the amounts can be posted to the customer's account. For consumer accounts, this posting will usually take place overnight, although some depository institutions may be able to post some transactions in real time during the day. ACH credit transactions are value dated so that funds from these transactions are typically available at the opening of business on the value date. Check transactions are subject to return and, therefore, funds may not be made available until after some time period to guard against the potential for return. For check deposits to consumer accounts, this time period is subject to limitations under the EFAA. In addition to the availability considerations based on the account holding depository institution's operations and risk, deposits may be made by means such as mail, adding uncertainty as to when the deposit will actually be received so that it can be credited to an account.

Just as is the case of deposits to an account, the timing of charges to an account is often uncertain. This is particularly true in the case of checks mailed to the payee. The combination of the time required for the payee to receive the check and the time necessary for the check to be collected make it difficult for a depositor to predict when such a check will be charged to the

depositor's account. This situation is even more difficult for the account holding depository institution which usually does not know what checks its customer has written.

Although debit card transactions often are subject to an authorization process that is based on the consumer's available balance at the time of the transaction, at the time of authorization, the account holding depository institution will not know how this transaction will relate to other transactions that will be posted to the account. In other words, because check and ACH transactions, and potentially other transactions, including both deposits and payments, will typically be posted late at night, at any time during the day whether honoring a debit card transaction will result in an overdraft is at best an educated guess on the part of the account holding bank. In addition, authorizations may not reflect the actual transaction amount of the transaction because, as in the case of many gas stations and hotels, the authorization takes place before the transaction is completed.

### **Overdraft Payment Practices**

Because of the uncertainties as to the amounts that will be available in an account to pay transactions, and as a matter of customer service, depository institutions have historically honored transactions for their good customers that would result in an overdraft to the customer's account. Years ago the determinations as to which transactions to honor were made on a case-by-case basis by a bank officer each morning based on the posting process from the night before. In some cases, the bank officer would telephone customers to determine whether they would be able to cover the payment. This process may have favored customers known to the officer and was, in some cases, subject to abuse when some bank customers found that they could obtain loans of significant duration because a bank officer was loath to dishonor a check for an important depositor. Although they entailed credit risk, these overdrafts were not credit in

the traditional sense. They were not incurred as a matter of right—recurring transactions were not expected and payment was due immediately, rather than at some future date.

In addition, historically, many depository institutions have offered their depositors overdraft lines of credit under which the depository institution makes a loan to the depositor to cover any overdraft. However, many depositors choose not to open these lines of credit, either due to a lack of foresight, concern that the availability of the credit will interfere with their budget discipline or because they have found these lines of credit to be inconvenient. Often, the credit, for an overdraft line of credit, is not paid off by the next deposit to the account, rather it and interest charges continue until the depositor takes an affirmative step to repay the credit.

More recently, for consumers, depository institutions have automated this decision-making process based on such factors as the age of the account, the regularity of deposits and the prompt payment of any prior overdrafts. Frequently, a limit of a few hundred dollars is applied to limit the account holding depository institution's risk. These automated programs make the ability to incur overdrafts in order to complete payments available to consumers on a more equitable basis. Automated programs also greatly reduce the costs to the depository institution, and, in the context of modern nationwide banking, where individual depositors are not well known to bank officers, automated programs are the only practical way for many depository institutions to address the overdraft issue.

Some depository institutions maintain these automated programs but choose not to inform their depositors of the parameters of their overdraft programs. Other depository institutions choose to tell their customers about their programs, including the criteria to be eligible to have overdrafts honored and the size of the overdrafts that may be honored. The practice of advising consumers about an overdraft payment program has led to concerns that

some banks may be promoting overdrafts as an expensive form of short-term loan. This concern, as well as others, has led the federal depository institution regulatory agencies to issue guidance on consumer overdraft payment programs and has led the Board to specifically address overdraft payment programs in its Regulation DD, Truth in Savings.

### **Guidance and Regulation for Overdraft Programs**

Although many depository institutions offer overdraft lines of credit that are open-end credit plans subject to the disclosure requirements of the Truth in Lending Act and Regulation Z, overdraft programs typically are not subject to Regulation Z because the depository institution retains discretion on whether or not to pay the overdraft. Thus, the consumer depositor does not have a right to obtain credit, one of the criteria for coverage under Regulation Z. In addition, with respect to checks and ACH transactions, overdraft programs are often not covered under Regulation Z because the charge for the overdraft is the same as the charge for returning the transaction so that the program does not charge a finance charge as defined under Regulation Z.

In part, in order to assure that consumers have an adequate understanding of overdraft programs, in February of 2005 the federal depository institution regulatory agencies issued guidance on the operation of these programs. The Board, the Federal Deposit Insurance Corporation, the National Credit Union Administration and the Office of the Comptroller of the Currency joined in guidance and the Office of Thrift Supervision issued substantially similar, but separate, guidance. Although both sets of guidance were focused on overdraft programs that were disclosed, or “promoted,” by depository institutions to their customers, the agencies noted that a set of best practices included in the guidance also may be useful for other methods of covering overdrafts. The multi-agency guidance called for the following best practices:

- Avoid promoting poor account management;



- Fairly represent overdraft protection programs and alternatives;
- Train staff to explain program features and other choices;
- Clearly explain the discretionary nature of program;
- Distinguish overdraft protection services from “free” account features;
- Clearly disclose program fees;
- Clarify that fees count against the disclosed overdraft protection dollar limit;
- Demonstrate when multiple fees will be charged;
- Explain the impact of transaction clearing policies;
- Illustrate the type of transactions covered;
- Provide election or opt-out of service;
- Alert consumers before a transaction triggers any fees;
- Prominently distinguish balances from overdraft protection funds availability;
- Promptly notify consumers of overdraft protection program usage each time used;
- Consider daily limits on the consumer’s costs;
- Monitor overdraft protection program usage; and
- Fairly report program usage.

The Office of Thrift Supervision guidance was almost identical but included an additional best practice to not manipulate transaction clearing rules to inflate fees. The agency guidance is comprehensive. The opt-out feature, coupled with the disclosure requirements, give consumers the ability to choose whether or not they want to have their overdrafts covered within the parameters of the program. Further, the guidance is backed by the enforcement powers of the agencies, which includes the power to act on individual unfair and deceptive acts and practices

under the Federal Trade Commission Act and, in the case of the National Credit Union Administration, rules against inaccurate or deceptive advertising.

In addition to the overdraft guidance, effective July 1, 2006, the Board amended Regulation DD, Truth in Savings, to add new advertising requirements and periodic statement disclosures for overdraft programs that are disclosed, or “promoted,” by the account holding depository institution. The periodic statement requirements include not only current fees, but also year-to-date fees. In addition, actions that trigger the requirements for advertising or promoting overdrafts include disclosing an overdraft limit to a depositor or including an overdraft in a balance disclosed by any means, including at an ATM or by means of a telephone response machine. Effective October 1, 2006, the National Credit Union Administration adopted similar rules for credit unions.

### **Potential Additional Requirements**

Proposed legislation would go beyond the agency guidance and regulatory requirements with respect to overdrafts in consumer accounts. For example, H.R. 946 would require prior consent and open-end credit disclosures under Regulation Z before fees could be charged for certain overdrafts. In addition, consumers would have to be given notice and the ability to opt out of certain transactions at ATMs and point-of-sale before an overdraft fee could be imposed.

I believe that the better approach to concerns about consumer protection in overdraft programs is appropriate enforcement of the agency guidance and regulatory requirements rather than additional detailed legislation. The payment and account management process is complex and, in most cases, highly automated so that seemingly simple changes may be extremely costly and time consuming to implement, dwarfing any potential benefit. For example, an opt out for

individual transactions that may cause overdrafts because of ATM or point-of-sale transactions could be extremely costly as it could require a retooling of the entire current payment card transaction authorization process. Even with the retooling, balances on which authorizations are based would not accurately reflect whether a transaction would ultimately result in an overdraft because of uncertainties in posting and the finality of funds discussed above. Moreover, individual ATM or point-of-sale transactions that themselves would not result in an overdraft may cause transactions processed later, such as check transactions, to overdraw the account. This would be an inefficient way to help a few consumers keep track of their deposit account balances, particularly at a time when daily balances are often available online.

Similarly, treating overdrafts as credit under Regulation Z raises questions as to how a meaningful annual percentage rate for a transaction that is based on a fixed fee can be disclosed prior to the consumer both incurring and repaying the overdraft. On the other hand, mandating that overdraft fees be in the form of periodic rates may make the service indistinguishable from overdraft lines of credit, which many consumers have chosen not to open, and for which many consumers would not qualify. Finally, it is by no means clear that the most effective way to value or explain all financial transactions is through reference to an annual percentage rate. In the case of overdrafts, a fixed fee that is disclosed to the consumer in advance is probably more effective at enabling a consumer to anticipate the consequences of an overdraft, than expressing the same charge as an annual percentage rate.

Thank you. I would be happy to answer any questions.